

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: Garrick Analyst: Scott McFarlane Bill Number: AB 2292
Related Bills: See Legislative History Telephone: 845-6075 Introduced Date: February 21, 2008
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Health Savings Account (HSA) Deduction Conformity

SUMMARY

This bill would allow the same deduction on California personal income tax returns for contributions to an HSA as is allowed on federal personal income tax returns.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to help businesses and individuals pay for medical expenses.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and specifically operative for taxable years beginning on or after January 1, 2008.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Amendments 1, 2, 3, 4, 5 and 7 are suggested to eliminate unnecessary language. Amendment 6 is suggested to correct an Internal Revenue Code (IRC) section number reference.

ANALYSISFEDERAL/STATE LAWCurrent Federal Law*Health Savings Accounts*

Under federal law, individuals with a high deductible health plan (HDHP), and no other health plan other than a plan that provides certain permitted coverage, may establish an HSA.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Selvi Stanislaus

4/14/08

In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.

Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual in determining adjusted gross income (AGI¹). Contributions to an HSA are excludable from income and employment taxes if made by the employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10%. The 10% additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100% of the annual deductible under the HDHP,² or (2) (for 2007) \$2,850 in the case of self-only coverage and \$5,650 in the case of family coverage.³ Contributions in excess of the maximum contribution amount are generally subject to a 6% excise tax.

Health Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements (HRAs)

Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health FSAs and HRAs. Health FSAs typically are funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, then the compensation that is foregone is not includible in gross income or wages and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the general requirements relating to cafeteria plans, including a requirement that a cafeteria plan generally may not provide deferred compensation. This requirement often is referred to as the "use-it-or-lose-it-rule."

HRAs operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis, and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year. Reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA, but not under a health FSA.

¹ Adjusted Gross Income (AGI) includes all gross income reduced by "above-the-line" deductions. Above-the-line deductions include certain trade or business deductions, contributions to an MSA, alimony paid, and contributions to pension and annuity plans.

² The limits are indexed for inflation. For 2006, a high deductible plan is a health plan that has a deductible that is at least \$1,050 for self-only coverage or \$2,100 for family coverage and that has an out-of-pocket expense limit that is no more than \$5,250 in the case of self-only coverage and \$10,500 in the case of family coverage.

³ These amounts are indexed for inflation.

Subject to certain limited exceptions, health FSAs and HRAs constitute other coverage under the HSA rules.

Tax Relief and Health Care Act (TRHCA) of 2006 (Public Law 109-432), enacted December 20, 2006

Starting in 2007, the TRHCA made the following six changes to HSAs:

1. FSA and HRA Terminations to Fund HSAs

Certain amounts in a health FSA or HRA are allowed to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006, or (2) the balance in the health FSA or HRA as of the date of the distribution.

2. Repeal of Annual Deductible Limitation on HSA Contributions

Limits on the annual deductible contributions that can be made to an HSA are modified so that the maximum deductible contribution is not limited to the annual deductible under the HDHP. Thus, starting in 2007, the maximum aggregate annual contribution that can be made to an HSA is \$2,850 (for 2007) in the case of self-only coverage and \$5,650 (for 2007) in the case of family coverage.

3. Modification of Cost-of-Living Adjustment

In the case of adjustments made for any taxable year beginning after 2007, the Consumer Price Index for a calendar year is determined as of the close of the 12-month period ending on March 31 of the calendar year (rather than August 31 as under present law) for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (i.e., the contribution limits and the HDHP requirements).

4. Contribution Limitation Not Reduced for Part-Year Coverage

In general, starting in 2007, individuals who become covered under an HDHP in a month other than January are allowed to make the full deductible HSA contribution for the year rather than, as under prior law, being required to prorate the deduction based on the number of months the individual was enrolled in a HDHP.

5. Exception to Requirement for Employers to Make Comparable Health Savings Account Contributions

Enacts an exception to the comparable contribution requirements to allow employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. For example, an employer is permitted to make a \$1,000 contribution to the HSA of each nonhighly compensated employee for a year without making contributions to the HSA of each highly compensated employee.

6. One-Time Distribution from Individual Retirement Arrangements (IRAs) to Fund HSAs

Allows a one-time contribution to an HSA of amounts distributed from an individual IRA. The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under these rules are not includible in income to the extent that the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 10% additional tax on early distributions.

Current California Law

California has not conformed to any of the federal HSA provisions. The California personal income tax return starts with federal AGI and requires adjustments to be made for differences between federal and California law. Adjustments relating to HSAs are required under current law, as follows:

- A taxpayer taking a deduction on the federal personal income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer's California return.
- Contributions to an HSA made on the employee's behalf by their employer are added to AGI on the employee's California return. These include salary reduction contributions made through a cafeteria plan

Although California has not conformed to HSAs, California law is conformed to the federal rules for MSAs and allows a deduction equal to the amount deducted on the federal return for the same taxable year. California imposes a 10% additional tax rather than the 15% additional federal tax on distributions from an MSA not used for qualified medical expenses.

Because a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to AGI on the taxpayer's California return and as that MSA distribution is not treated as being made for qualified medical expenses it would, therefore, be subject to the MSA 10% additional tax.

Additionally, a federal tax-free qualified HSA funding distribution is not allowed under California law because California specifically does not conform to IRC section 223, relating to HSAs, even though California conforms to IRC section 408, relating to IRAs.

Under California law, any distribution from an IRA to an HSA must be added to AGI on the taxpayer's California return and would be subject to a 2 ½% additional tax under the rules for premature distributions.

Starting with taxable year 2008, this bill would conform to the federal HSA provisions, as follows:

1. Allows the same above-the-line deduction for contributions to an HSA by or on behalf of an individual and adopts the rules applicable to the trust itself in order for the trust to be exempt from tax. In addition, the disqualified distribution penalty applicable to HSAs is modified for California purposes to be 2 ½% instead of the federal rate of 10% to be consistent with the other California penalty provisions applicable to IRAs. Consistent with general conformity policy in other areas, the federal 6% excise tax on excess contributions and the federal estate tax provisions are not being conformed to by this bill.
2. Allows the same exclusion from an employee's gross income for the amount of any contributions to an HSA (including salary reduction contributions made through a cafeteria plan) made on the employee's behalf by their employer.
3. Allows rollovers from MSAs to be made to HSAs, as well as rollovers between HSAs, without penalty.
4. Adopts the same \$50 penalty for failure to make required reports.
5. Allows certain amounts in health FSAs or HRAs to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements.
6. Conforms to repeal of annual deductible limitation on HSA contributions.
7. Determines the Consumer Price Index for a calendar year as of the close of the 12-month period ending on March 31 of the calendar year (rather than August 31 as under prior law) for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (i.e., the contribution limits and the HDHP requirements).
8. Allows individuals who become covered under an HDHP in a month other than January to make the full deductible HSA contribution for the year rather than being required to prorate the deduction based on the number of months the individual was enrolled in an HDHP.
9. Conforms to an exception to the comparable contribution requirements to allow employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. For example, an employer is permitted to make a \$1,000 contribution to the HSA of each nonhighly compensated employee for a year without making contributions to the HSA of each highly compensated employee.
10. Allows a one-time contribution to an HSA of amounts distributed from an IRA. The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under these rules are not includible in income to the extent the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 2½% additional tax on early distributions.

TECHNICAL CONSIDERATIONS

Sections 5 and 6 contain language that is redundant and unnecessary. Amendments 1, 2, 3, 4, 5 and 7 are suggested to delete the unnecessary language and renumber the subsequent sections.

Section 10 of the bill contains a reference to section 233(h) of the Internal Revenue Code. It should instead reference section 223(h). Amendment 6 is suggested to correct this error.

LEGISLATIVE HISTORY

SBX1 10 (Maldonado, 2007/2008) is nearly identical to this bill, except that conformity to the federal HSA provisions would apply starting with taxable year 2006. That bill failed to pass the Senate Health Committee.

AB 84 (Nakanishi/Smyth, 2007/2008) is identical to this bill. That bill, as amended on March 12, 2007, was held in the Assembly Revenue and Taxation Committee.

AB 142 (Plescia, 2007/2008) is nearly identical to this bill. That bill would conform to federal HSA provisions starting with taxable year 2008, which is the same as this bill; however, AB 142 specified a different nonconformity period than this bill. That bill was held in the Senate Revenue and Taxation Committee.

AB 245 (DeVore, 2007/2008) is identical to AB 142. That bill was held in the Assembly Revenue and Taxation Committee.

ABX1 4 (Nakanishi, 2007/2008) is identical to this bill. That bill, as introduced on September 18, 2007, is at the Assembly desk.

SB 25 (Maldonado and Runner, 2007/2008) is identical to this bill. That bill was held in the Senate Revenue and Taxation Committee.

AB 661 (Plescia, 2005/2006) was substantially the same as this bill. That bill was held in the Assembly Revenue and Taxation Committee.

AB 2010 (Plescia, 2005/2006) was nearly identical to this bill except that conformity to the federal HSA provisions would apply starting with taxable year 2007. That bill was held in the Assembly Revenue and Taxation Committee.

SB 173 (Maldonado, 2005/2006) was nearly identical to this bill, except that conformity to the federal HSA provisions would apply starting with taxable year 2006. That bill was held in the Senate Revenue and Taxation Committee.

SB 1584 (Runner and Ackerman, 2005/2006) would have retroactively conformed to the federal HSA provisions starting with taxable year 2004 and would allow amended returns to be filed. That bill was held in the Senate Revenue and Taxation Committee.

SB 1787 (Ackerman, 2005/2006) would have retroactively conformed to the federal HSA provisions starting with taxable year 2004 and would allow amended returns to be filed. That bill was held in the Senate Revenue and Taxation Committee.

AB 2315 (Maldonado/ Nakanishi, 2003/2004), as amended May 17, 2004, was nearly identical to this bill, except that the federal HSA provisions would apply starting with taxable year 2006. That bill was held in the Assembly Appropriations Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* does not impose a personal income tax so a comparison to *Florida* is not relevant. *Illinois, Massachusetts, Michigan, Minnesota, and New York* conform to the federal deduction for contributions to HSAs.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact for AB 2292 Effective for Taxable Years BOA 1/1/08 (\$ in Millions)		
2008-09	2009-10	2010-11
-\$40	-\$45	-\$55

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact of the bill would be determined by: (1) the amount of contributions to HSAs deducted on tax returns, (2) the amount of contributions to HSAs made on behalf of employees (including salary reduction contributions), and (3) the amount of funds in MSAs, health FSAs, and HRAs that are rolled over to HSAs, and (4) marginal tax rates of taxpayers deducting or excluding such contributions.

1. For taxable year 2004, tax return data indicates total HSA adjustments on Schedule CA, California Adjustments, were \$20 million. (This means that taxpayers made tax-deductible HSA contributions of \$20 million for federal purposes that were reversed, i.e., "adjusted," for state purposes.) For taxable year 2005, total HSA adjustments on Schedule CA were \$55 million.

Recent articles indicate the number of HSAs nationwide doubled during 2005 and again in 2006. To derive the estimates, this substantial growth rate is used through 2007 and is decreased thereafter to more sustainable rates. For taxable year 2008, contributions by California individual taxpayers to HSAs are projected at \$332.4 million. Applying a marginal tax rate of 7% results in a revenue loss of approximately \$23.3 million (\$332.4 million x 7%).

2. Contributions made by an employer on behalf of an employee (including salary reduction contributions made through a cafeteria plan), cannot be identified on a tax return. It is not known how many additional HSAs may exist as a result of this contribution arrangement. For purposes of this estimate, it is assumed that employer contributions on behalf of an employee are roughly 25% of the amount made by individuals, or approximately \$83 million in 2008 ($\$332.4 \text{ million} \times 25\% \approx \83.4 million). Applying a marginal tax rate of 7% results in an additional revenue loss of approximately \$5.8 million for 2008 ($\$83.4 \text{ million} \times 7\% \approx \5.8 million).
3. The potential rollover of balances in MSAs is estimated. For taxable year 2002, tax return data indicate deductible MSA contributions totaling \$11.6 million were reported on 4,600 tax returns. It is possible that balances in some MSAs have already been rolled over. In addition, there is no requirement that balances have to be rolled over. It is assumed that 50% of these accounts, 2,300, would be rolled over and each account has an average balance of \$6,250. This average balance equates to two-and-a-half years of average contributions (2.5 years \times \$2,500 average annual contribution = \$6,250). Applying a marginal tax rate of 7% results in a loss of an additional \$1 million ($2,300 \times \$6,250 \times 7\% \approx \1 million). It is anticipated that rollovers would likely occur in the initial one or two years of conformity. Therefore, the \$1 million loss is divided between taxable year 2008 and taxable year 2009, or \$0.5 million each taxable year.
4. For expanded HSA provisions included in the TRHCA of 2006, estimates are based on a proration of federal estimates developed for the act. For these provisions, the conformity estimate is an additional loss of \$2.2 million for taxable year 2008. This estimate was computed as follows (\$ in millions):
 - Federal estimates developed for the act were: -\$50, -\$64, -\$70, and \$80 for federal fiscal years ending September 30, 2008, 2009, 2010, and 2011, respectively.
 - Federal fiscal year estimates are converted to taxable year estimates: -\$55, -\$66, -\$73, and -\$83 for taxable years 2008, 2009, 2010 and 2011, respectively.
 - The applicable proration factor is applied to the federal taxable year estimates to derive taxable year estimates for the state. For this issue, the applicable proration factor is 4.1%. Applying the 4.1% to the federal taxable year estimates results in losses of: -\$2.2, -\$2.7, -\$3.0, -\$3.4 for taxable years 2008, 2009, 2010 and 2011, respectively.

For taxable year 2008, the estimated loss is approximately \$32 million ($\$23.3 \text{ million} + \$5.8 \text{ million} + \$0.5 \text{ million} + \$2.2 \text{ million} \approx \32 million). Tax year estimates are converted to the cash flow fiscal year revenue estimates reflected in the table.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2292
As Introduced February 21, 2008

AMENDMENT 1

On page 3, strikeout lines 1 to 28.

AMENDMENT 2

On page 3, line 29, after SEC., strikeout "7" and insert:

5

AMENDMENT 3

On page 3, line 37, after SEC., strikeout "8" and insert:

6

AMENDMENT 4

On page 4, line 5, after SEC., strikeout "9" and insert:

7

AMENDMENT 5

On page 4, line 26, after SEC., strikeout "10" and insert:

8

AMENDMENT 6

On page 4, line 38, after Section, ~~strikeout~~ "233(h)" and
insert:
223(h)

AMENDMENT 7

On page 5, line 28, after SEC., strike out "11" and insert:

9